D. LITIGATION BY IRC 501(c)(3) ORGANIZATIONS

1. Introduction

IRC 501(c)(3) provides that an organization organized and operated exclusively for "charitable" purposes may qualify for exemption from federal income tax. The Service has recognized as charities certain types of organizations that engage in litigation. The purpose of this topic is to discuss the basic types of litigating organizations that apply for recognition of exemption under IRC 501(c)(3): (1) legal aid organizations; (2) human and civil rights defense organizations; (3) public interest law firms; and, (4) organizations that attempt to achieve charitable goals through the institution of litigation as a plaintiff.

2. Legal Aid Organizations

The providing of legal service is ordinarily a commercial activity and, absent special circumstances, does not qualify as charitable. One such special circumstance involves legal aid organizations, which have been recognized as IRC 501(c)(3) organizations for many years. Rev. Rul. 69-161, 1969-1 C.B. 149, describes the classic legal aid society and holds that an organization that provides "for legal services to indigent persons otherwise financially incapable of obtaining such services" is exempt under IRC 501(c)(3). By providing essential legal services to the indigent, the organization relieves the poor and distressed; therefore, the activity is charitable. This holding is amplified in Rev. Rul. 78-428, 1978-2 C.B. 177, which concludes that an organization providing legal services to indigent persons may qualify for exemption under IRC 501(c)(3) even though it charges for its services. However, the fees must be based on the indigents' limited abilities to pay rather than on the type of service rendered. In other words, the fees paid must be nominal.

The services provided by legal aid organizations are in no way unique and the litigation in which they engage does not accomplish any charitable purpose. The bulk of a legal aid society's case work usually involves divorce and domestic relations; consumer problems; criminal defense; and, other routine personal problems. Charitable classification of these organizations rests solely on the basis that they provide essential services to the poor who are otherwise unable to obtain them and they provide such services in a charitable manner.

3. Human and Civil Rights Organizations

Reg. 1.501(c)(3)-1(d)(2) provides that it is a charitable purpose to promote social welfare by defending "human and civil rights secured by law." Therefore, organizations, whose purpose is to provide representation to others (or to institute litigation as a party plaintiff) in cases involving the defense of human and civil rights, may be considered charitable organizations for purposes of IRC 501(c)(3). An example of this type of organization is found in Rev. Rul. 73-285, 1973-2 C.B. 174. The organization described there provides funds to defend members of a religious sect in legal actions involving substantial constitutional issues of state abridgement of religious freedom.

The scope of the rights encompassed within the phrase "human and civil rights secured by law" obviously includes those rights discussed in Rev. Rul. 73-285:

> Freedom of religion is one of the fundamental freedoms guaranteed by the United States Constitution. The First Amendment to the Constitution as made applicable to the states by the Fourteenth Amendment, specifically forbids the states from enacting laws prohibiting the free exercise of religion.

There has been, however, considerable controversy over how the phrase is to be construed in other cases.

In accord with the trend of recent court decisions, such as National Right to Work Legal Defense and Education Foundation, Inc. v. Commissioner, 487 F. Supp. 801 (E.D. N.C. 1979) and State of Maine v. Thibutot 448 U. S. 1 (1980), the Service broadly construes the phrase "human and civil rights secured by law" so as to include rights provided not only by the Constitution of the United States or of a state, but also by federal or state statutes. Thus, if the subject matter of an organization's litigation is a federal statute guaranteeing the right of union members to democratic process in union elections or a state statute establishing the right to be free from discrimination in employment based on sex, then the organization's activities will constitute the defense of "human and civil rights secured by law" under Reg. 1.501(c)(3)-1(d)(2).

Where statutes are involved, however, it is important to scrutinize exactly what is at issue in the case. One example of litigation brought under a statute is a class action suit brought under Title VII of the Civil Rights Act of 1964. Title VII

provides that it is unlawful for an employer to discriminate against an individual on the basis of sex. Therefore, the right to be free from discrimination on the basis of sex in employment opportunities is a human and civil right secured by law. In contrast, consider the facts presented in Retired Teachers Legal Defense Fund, Inc. v. Commissioner, 78 T.C. 280 (1982). In that case, the petitioner was organized to protect the financial stability of the New York City Teachers' Retirement System and the contributions and pensions of retiree members of that system. The organization brought suit on behalf of approximately 25,000 retired teachers and sought to secure restitution of an alleged $204 million loss of the system's assets. The court found that the petitioner's litigation was comparable to a stockholder's derivative suit designed to benefit directly the private property interests of a relatively small segment of the public. The petitioner was held to be not entitled to exemption as an organization described in IRC 501(c)(3).

Therefore, in determining whether the right being asserted is "a human and civil right secured by law" there must be (1) a law (constitutional or statutory) and (2) an assertion that could reasonably be said to promote this right by attempting to define either its extent or limitation.

In these cases, however, an organization's entitlement to exemption under IRC 501(c)(3) does not follow necessarily from a finding that its activities constitute the defense of human and civil rights. Such activities are charitable only if they serve a public rather than a private interest, as required by Reg. 1.501(c)(3)-1(d)(1)(ii). The following criteria are relevant in determining whether such an organization serves a public rather than a private interest:

1. whether the litigation will have a substantial impact beyond the interest of the litigants;

2. whether the selection of cases by the organization for its support is made by a board or committee that is representative of the public and is not controlled by employees, persons who litigate on behalf of the organization, or by any commercial entity;

3. whether the primary source of financial support of the organization is from the persons being represented; and,

4. whether there is an arrangement whereby a donor may claim, directly or indirectly, a charitable deduction for the cost of litigation that serves the donor's private benefit.

The above criteria are not simply a checklist. They involve the weighing of the circumstances and nuances of each case. Thus, a class action suit in the area of employment discrimination may turn out to serve a private interest if the organization was formed as a result of an agreement between an attorney and an individual client regarding the attorney's compensation.

In summary, charitable classification of these organizations is based on the recognition of the importance of legally guaranteed human and civil rights. Securing such rights for each individual is of sufficiently broad public concern that litigation involving these rights promotes social welfare. The social welfare aspect of any particular case, however, may be negated by a finding of overriding private benefit.

4. Public Interest Law Firm

This third category of litigating organizations is of more recent vintage than the two already discussed. Because of the nature of its activities and the variety of issues litigated, procedures and definitions respecting its operations are not tightly structured. Rev. Rul. 75-74, 1975-1 C.B. 152, sets forth the rationale for recognizing public interest law firms exempt under IRC 501(c)(3). There it is pointed out that although the legal services that the public interest law firms provide are not unique, they do provide representation for issues of significant public interest in cases that would not be economically feasible for the traditional private law firms.

The representation may be in some specific area of public concern, such as protection of the environment, or more broadly, upon any subject of presumptively public interest. Other areas frequently represented by public law firms include: urban renewal; prison reform; freedom of information; injunction suits challenging governmental and private action or inaction; and, "test" cases of significance to the public.

The public benefits from having these important issues presented to and resolved by the courts. Charitable classification is based not upon the particular positions advocated, but upon the fact that legal representation is made available in important cases where it would not be available from private firms.

In 1970, public interest law firms presented a peculiar problem. Unlike legal aid organizations and organizations engaged in the defense of human and civil

rights, there was no clear precedent for exempting public interest law firms. Therefore, it was necessary to develop guidelines under which public interest law firms could obtain advance rulings on which contributors and organizations might rely. These guidelines were first published in a News Release on November 12, 1970, and then as Rev. Proc. 71-39, 1971-2 C.B. 575.

In Rev. Proc. 71-39 a two part qualification test is established. First the organization must present a program designed to serve the public interest through litigation. Second, it must be operated in accordance with specified guidelines. These guidelines are summarized below:

1. The organization must show that its role in litigation is representation of a broad public interest rather than a private interest. Individual litigants are generally ineligible for representation where their financial interests are at stake, since such issues generally would warrant representation from private legal sources.

2. The organization may not accept fees for services except in accordance with procedures approved by the Service.

3. The organization should not attempt to achieve its objectives through disruption of the judicial process, illegal activity, or violation of applicable canons of ethics.

4. The organization must file with its annual information return, a description of cases litigated and the rationale for the determination that they would benefit the public generally.

5. The policies and programs of the organization must be set forth by a board of directors or committee that is representative of the public interest and not controlled by employees or persons who litigate for the organization or by any non-IRC 501(c)(3) organization.

6. The organization may not be operated in a manner that creates identification or confusion with a particular private law firm.

7. No arrangement may be made to provide a deduction for the cost of litigation that is for the private benefit of the donor.

8. The organization must meet the other requirements of IRC 501(c)(3) concerning inurement, legislative activities, and participation in political campaigns.

To complete guideline number two above, with respect to fees the Service published Rev. Proc. 75-13, 1975-1 C.B. 662. These fee guidelines are:

1. The organization does not seek or accept attorneys' fees from its clients as compensation for the provision of legal services.

2. The organization may accept attorneys' fees in public interest cases if such fees are paid by opposing parties and are awarded by a court or administrative agency or approved by such a body in a settlement agreement.

3. The organization does not use the likelihood or probability of a fee award as a consideration in its selection of cases.

4. The organization uses awarded fees exclusively for the purpose of defraying its normal operating expenses. No more than 50 percent of the total cost of its legal functions is defrayed from awarded fees. The percentage is to be calculated over a five year period, including the taxable year in which any awarded fee is received and the four preceding taxable years (or any lesser period of existence). Costs of legal functions include: attorneys' salaries, nonprofessional salaries, overhead, and other costs directly attributable to the performance of the organization's legal functions. An organization may submit a ruling request where an exception to the above 50 percent limitation appears warranted.

5. Attorneys' fees are paid to the organization rather than to individual staff attorneys. The organization compensates its attorneys and employees on a straight salary basis, not exceeding reasonable salary levels and not established in reference to any fees recovered. For example, the attorneys' salaries may conform to those of comparable government attorneys.

6. The organization does not accept awarded fees or seek such fees in any circumstances that would result in any conflict with state statutes or professional canons of ethics.

7. In addition to the information required by section 3.04 of Rev. Proc. 71-39, the organization files with its annual information return a report of all fees sought and recovered.

The rationale for these guidelines and especially the rule against client fees and the restricted approval of court awarded fees is set forth in Rev. Ruls. 75-75 and 75-76, 1975-1 C.B. 154. Recognizing that the practice of law is competitive, once client fees are permitted, the expectation of client fees or compensation for the legal services rendered would be a motivating factor in accepting cases. Thus, Rev. Rul. 75-75 states: "If a public interest law firm has an established policy of charging or accepting attorneys' fees from its clients, the representation provided cannot be distinguished from that available through traditional private law firms."

Rev. Rul. 75-76 holds that the after-the-fact award of attorneys' fees is not necessarily a motivating factor in selecting cases and with the restrictions set forth in Rev. Proc. 75-13 will not adversely affect exemption.

The public interest law firm fee issue is further discussed in Rev. Rul. 76-5, 1976-1 C.B. 146, where a public interest law firm entered into a fee sharing arrangement with a private or outside attorney. Under the arrangement the attorney would keep any part of a court awarded fee above the amount the public interest law firm had already agreed to pay the attorney for the particular case. The Rev. Rul. holds that Rev. Proc. 75-13 is applicable and that fee-sharing or variable compensation agreements with private attorneys may also prove to be a motivating factor in case selection. Thus, such an arrangement will bar exemption.

To summarize, public interest law firms are charities only so long as they provide representation in cases of important public interest that are not economically feasible for private firms. In the typical public interest case, no individual plaintiff has a sufficient economic interest to warrant the retention of a traditional law firm, and because the interested individuals are so varied or dispersed, it is not practical to rely on collective financing. In addition to the operation of a public interest litigation program, there must be conformity with the Service guidelines.

5. Organizations that Attempt to Achieve Charitable Goals Through the Institution of Litigation

This is the final, most recent, and, in some respects, the most indistinct category of litigating organizations that may qualify for IRC 501(c)(3) exemption. Rev. Rul. 80-278, 1980-2 C.B. 175, is the landmark, and only published case in the area. The organization described there was organized for the purpose of protecting and restoring environmental quality. Its principal activity consists of instituting litigation as a party plaintiff under federal and state legislation. Typical of its litigation is a suit filed against a local manufacturer and the state environmental protection agency to enjoin the manufacturer from emiting pollutants from its plant and to require the state agency to enforce state air-quality legislation.

This newer type organization is distinguished from a public interest law firm in that the organization does not have its own staff of attorneys and does not provide legal representation to others. Instead, it retains private attorneys and files court cases in its own name.

Another distinguishing feature is that the organization's activities do not have a direct and immediate effect in improving the environment or making some other change. The organization described in Rev. Rul. 80-278 differs from other types of environmental organizations in that, instead of directly undertaking to beautify the community or preserve natural lands, its resources are utilized in an attempt to compel others to improve the environment. Thus, the particular activity in which it engages (litigation), is not in and of itself charitable. Recall that the litigation of a public interest law firm, discussed previously, is considered charitable per se. There the charitableness arose from the fact that representation is made available in cases of public importance where it would not usually be available from private sources.

One of the salient issues raised by the revenue ruling, therefore, is whether an organization with stated charitable purposes must engage in per se charitable acts in order to qualify for exemption under IRC 501(c)(3). Rev. Rul. 80-278 resolves this issue and elaborates on the issue of whether a litigating organization is precluded from litigating from a particular viewpoint on a controversial issue. It then sets forth a three part test to determine whether an organization of this type may qualify for IRC 501(c)(3) exemption as follows:

> In determining whether an organization meets the operational test, the issue is whether the particular activity undertaken by the

organization is appropriately in furtherance of the organization's exempt purpose, not whether that particular activity in and of itself would be considered charitable. Moreover, the fact that the activity reflects a particular viewpoint or opinion on a controversial issue does not preclude the organization from qualifying for exemption under section 501(c)(3) of the Code. See section 1.501(c)(3)-1(d)(2) of the regulations. Two organizations having the same charitable purpose may both be recognized as exempt even though their viewpoints on the subject may differ, and they may be undertaking differing, even conflicting, means to accomplish that charitable objective. See Restatement (Second) of Trusts, section 374 comment 1 (1959). The law of charity provides no basis for weighing or evaluating the objective merits of specific activities carried on in furtherance of a charitable purpose, if those activities are reasonably related to the accomplishment of the charitable purpose, and are not illegal or contrary to public policy.

Therefore, in making the determination of whether an organization's activities are consistent with exemption under section 501(c)(3) of the Code, the Service will rely on a three-part test. The organization's activities will be considered permissible under section 501(c)(3) if:

(1) The purpose of the organization is charitable;

(2) the activities are not illegal, contrary to a clearly defined and established public policy, or in conflict with express statutory restrictions; and

(3) the activities are in furtherance of the organization's exempt purpose and are reasonably related to the accomplishment of that purpose.

The revenue ruling went on to find that (1) preservation of the environment is charitable; (2) the private litigation activities are not only neither illegal nor contrary to public policy or any IRC 501(c)(3) restrictions, but also that they are sanctioned by Congress as a means to enforce environmental statutes; and, (3) the litigation activities are a reasonable means of accomplishing the preservation purpose.

The real impact of the revenue ruling lies in requirement (3). Requirement (3) acknowledges that an organization whose principal activity consists of instituting litigation as a party plaintiff, the fourth type of litigating organization, may qualify for IRC 501(c)(3) exemption, provided requirements (1) and (2) are met.